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No. 75-1285

IN THE

Supreme Court of the United States

OCTOBER TERM, 1975

UNITED STATES OF AMERICA, *Petitioner*

v.

PENN SECURITY LIFE INSURANCE COMPANY, *Respondent*

Petition for a Writ of Certiorari to the United States Court of Claims

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BRIEF OF RESPONDENT IN OPPOSITION

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OPINION BELOW

The opinion of the Court of Claims is reported at 524 F.2d 1155 and reproduced, with the Court of Claims' findings of fact, in the Appendix to the Petition for Certiorari.

QUESTION PRESENTED

The ultimate question in this case is whether Respondent qualified as a "life insurance company" during the years in issue under Section 801 of the Internal Revenue Code of 1954. Section 801 defines a life insurance company as an insurance company with life insurance reserves comprising more than 50% of its

total reserves. Respondent satisfied that reserve ratio test on the basis of the reserves it actually held in conformity with the requirements of state law.

The question presented is whether the Court of Claims correctly declined to include in the reserve ratio unearned premiums "attributed" to Respondent from unrelated companies whose risks it reinsured where (1) Respondent had no right to receive unearned premiums (as defined by Treas. Reg. § 1.801-3(e)) under its agreements with the reinsured companies, (2) Respondent did not own or control the reinsured companies nor did it otherwise actually or constructively hold the unearned premiums at any time, and (3) Respondent was not required by state law to maintain an unearned premium reserve on these reinsured risks.

STATUTES AND REGULATIONS INVOLVED

All of the statutes and regulations involved are set forth in the Petition for Certiorari, pp. 2-5,[1] with the exception of the following critical provision of the regulations.

> Treas. Reg. Sec. 1.801-5. Total reserves.—
>
> (a) *Total reserves defined.* For purposes of section 801(a) and § 1.801-3, the term "total reserves" is defined in section 801(c) as the sum of—
>
> (1) Life insurance reserves (as defined in section 801(b) and § 1.801-4),
>
> (2) Unearned premiums (as defined in paragraph (e) of § 1.801-3), and unpaid losses (whether or nor ascertained) (as defined in paragraph

[1] Reference to the Petition for Certiorari will hereafter be made in the form "(Pet., p. —)."

(g) of § 1.801-3), not included in life insurance reserves, and

(3) All other insurance reserves required by law.

The term "total reserves" does not, however, include deficiency reserves (within the meaning of section 801(b)(4) and paragraph (e)(4) of § 1.801-4), even though such deficiency reserves are required by State law. In determining total reserves, a company is permitted to make use of the highest aggregate reserve required by any State or Territory or the District of Columbia in which it transacts business, *but the reserve must have been actually held during the taxable year for which the reserve is claimed.* For example, during the taxable year 1958 a life insurance company sells life insurance and annuity contracts in States A and B. State A requires reserves of 10 against the life and 5 against the annuity business. State B requires reserves of 9 against the life and 7 against the annuity business. Assuming the company actually holds these reserves during the taxable year 1958, its highest aggregate reserve for such taxable year is the 16 required by State B. Thus, the company is not permitted to compute its highest aggregate reserve by taking State A's requirement of 10 against its life insurance business and adding it to State B's requirement of 7 against its annuity business. (Emphasis supplied).

STATEMENT

In brief summary, Respondent's principal business during the years in issue consisted of reinsuring risks underwritten by unrelated insurance companies in respect of credit life insurance policies issued by those companies to borrowers from Respondent's parent, a finance company. (Finding 4; Pet., p. 31a). Some

credit life policies included disability benefits, and these benefits were reinsured separately by Respondent. (Findings 13, 18; Pet., p. 36a, 40a).

Under its disability reinsurance agreements ("treaties") with the reinsured ("ceding") companies, Respondent received a monthly reinsurance premium solely for insurance coverage provided during the preceding month. (Finding 18; Pet., p. 40a). The ceding companies retained the unearned premiums received from their policyholders, as well as the income earned on those funds, and were accordingly required under state law to maintain unearned premium reserves on their policies. (Finding 16; Pet., pp. 38a-39a).

The Court of Claims, sitting *en banc,* rejected Petitioner's argument that unearned premium reserves held by the ceding companies should be attributed to Respondent under a "reserves-follow-the-risk" rule. The Court pointed out that charging Respondent with "unearned premiums" when it never received premiums paid in advance was contrary to the Treasury's own definition of the term.[2] Further, applying an attribution rule in Respondent's case, when it neither actually nor constructively held the ceding companies' unearned premiums, was inconsistent with the statute, the regulations, one of the Internal Revenue Service's own rulings,[3] and the rules and practices followed by state regulatory authorities in determining reserve requirements.

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[2] *See* Treas. Reg. § 1.801-3(e) providing that the term unearned premiums "means those amounts which shall cover the cost of carrying the insurance risk *for the period for which the premiums have been paid in advance . . .*" (Emphasis supplied).

[3] *See* Rev. Rul. 70-508, 1970-2 C.B. 136.

The Petition gives a fuller statement of the case (Pet., pp. 5-10), but contains an error that undermines the very basis of Petitioner's argument for certiorari.

The facts in *Economy Finance Corp.* v. *United States,* 501 F.2d 466 (7th Cir. 1974), *cert. denied,* 420 U.S. 947 (1975), were *not* "identical" to the instant case as characterized by Petitioner (Pet., p. 9). Although in both cases the terms of the disability treaties provided for payment of monthly reinsurance premiums as earned, the Court of Claims pointed out that in *Economy Finance* the actual facts were "quite different."

> "[T]he facts in *Economy Finance Corporation* differed from those in the present case in one important respect. Those taxpayers had agreements with the ceding company under which the latter was required to invest most of the unearned premium reserves in subordinated debentures of the parent of one of the taxpayers, and then to turn over the interest income received on those debentures as an 'additional commission' to the insurance agency partnership composed of stockholders of one of the related taxpayers. *See* 501 F.2d at 470. Thus, the *Economy Finance* taxpayers in effect received the proceeds of the unearned reserves even while in the hands of the ceding company. That arrangement was *quite different* from the one involved in the case at bar and could be understood as making that ceding company the agent of those taxpayers." (Pet., pp. 15a-16a) (Emphasis supplied).

In the present case, the Court of Claims found that the ceding companies were not agents of Respondent (Pet. p. 20a), and that "[Respondent] did not obtain or use the unearned premiums reflected in the statements of the ceding companies nor were such unearned pre-

miums credited, set apart or made available to [Respondent]." (Finding 16; Pet., p. 39a).

One final point. Petitioner's Statement does not inform the Court that more than half the dollar value of benefits reinsured by Respondent under these treaties were life insurance benefits (Finding 13; Pet., p. 36a), and that, even after attribution, more than half the reserves needed to cover the cost of carrying the life and disability risks ceded to Respondent would be life insurance reserves. (Finding 34, Pet., p. 52a). The benefits asserted for Petitioner's "reserves-follow-the-risk" rule are worth pondering when its effect would be to exclude a company insuring primarily life insurance risks from life insurance company status.[4]

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[4] This result occurs because life insurance reserves are computed on a *net* premium basis, taking into account only the cost of carrying the insurance risk, while unearned premium reserves on accident and health coverage have traditionally been computed on a *gross* basis to include not only the cost of carrying the risk but also "loading" costs including commissions, overhead, and profit. (Finding 32, Pet., p. 50a). With such an apples versus oranges comparison, an insurer writing approximately equal amounts of life and accident and health insurance over the same term will always have substantially more accident and health unearned premium reserves than life insurance reserves.

Despite pious protestations by Petitioner that it is only interested in reflecting *risks* assumed in the reserve ratio test, it maintained below that the ceding companies' unearned premiums should be attributed to Respondent on a *gross* basis, notwithstanding the Court's finding that the "loading" portion of the attributed unearned premium reserves is not a true insurance reserve at all but merely a solvency reserve. (Finding 32, Pet., p. 50a). Respondent argued that "gross attribution" was inconsistent with the theory of Petitioner's "reserves-follow-the-risk" rule, and that in any event Treas. Reg. § 1.801-3(e) limited the unearned premiums includible in the reserve ratio to that portion needed to "cover the cost of carrying the insurance risk." The Court of Claims found it unnecessary to reach these arguments in view of its conclusion that no attribution was justified in Respondent's case.

REASONS FOR DENYING THE WRIT

This Court should not accept Petitioner's invitation to rewrite a specialized statutory tax scheme in a technical area where the issues have been settled by Petitioner's own regulations for over 50 years. No conflict of decisions compels the Court's review; as noted, *Economy Finance* and this case were not decided on "identical facts" and the decisions can be reconciled. The Court of Claims' decision affects only a segment of a single industry and the revenue impact is insignificant compared with other current tax issues affecting the entire life insurance industry. Petitioner itself opposed certiorari when the taxpayer in *Economy Finance* petitioned for review barely a year ago.

The attribution of unearned premiums by the Seventh Circuit in *Economy Finance* can be justified on traditional agency grounds because the reinsurers there actually or constructively received the unearned premiums by reason of a side-agreement with the ceding company. See p. 5 *supra*. *Compare Superior Life Insurance Co.* v. *United States*, 462 F.2d 945 (4th Cir. 1972), similarly distinguished by the Court of Claims on the grounds, *inter alia*, that attribution could be justified on agency or constructive receipt principles:

> ". . . None of the facts on which the decision in *Superior Life* turned—(1) the agency relationship between the holder of the premiums and the insurance company, (2) the free availability of unearned premiums to the insurance company, and (3) identity of control between the parent-agent and subsidiary-insurance company—is present here. Since the taxpayer in *Superior Life* 'constructively received' unearned premiums under long-accepted principles of tax law, the Fourth Circuit's decision is entirely consistent with the

fact that the existence of unearned premiums depends upon the mode of premium payment." (Pet., pp. 19a-20a).

Thus, there is no square conflict between this case and *Economy Finance* or *Superior Life*. The Court of Claims has indicated it would have reached the same result as the Fourth and Seventh Circuits if presented with the very different facts of those cases.

To be sure, the Seventh Circuit rationalized its decision not on agency grounds but on the Government's "reserves-follow-the-risk" argument. That it used the wrong reason to reach a justifiable result does not create a conflict with *Penn Security,* however. The Seventh Circuit was misinformed regarding the statutory scheme,[5] and was presented with an extreme set of facts. It may correct itself if a case with *Penn Security's* facts is ever brought before it. If it or some other appellate court should subsequently impose attribution where the facts do not justify that conclusion

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[5] The Seventh Circuit apparently believed it had to rewrite the life insurance company definitional test because no other mechanism was available to prevent abuses of the deferral privilege accorded to companies who qualify for life insurance company tax treatment. The Government had argued that once a company qualifies for the benefits of life insurance company taxation, the deferral privilege cannot be terminated until the company itself "takes appropriate actions." See Economy Finance Corp. v. United States, *supra,* 501 F.2d at p. 476. The Seventh Circuit was not told that Congress had provided its own mechanism for guarding against abuses of the statutory scheme by placing statutory limitations on the deferral privilege even when a company meets the life insurance company definitional test. See § 815(d)(4), I.R.C. 1954. Nor was it informed that Congress was quite aware of reinsurance arrangements in which the ceding company holds reserves on reinsured risks, yet provided only a limited, *optional* attribution rule for this situation. See section 820, I.R.C. 1954; *compare* Rev. Rul. 70-508, 1970-2 C.B. 136.

on agency or constructive receipt principles, this Court may then consider whether it wants to review the issue.

For decades, Petitioner's own regulations have restricted reserves which may be taken into account in the reserve ratio test to those "actually held [by the company] during the taxable year," Treas. Reg. §1.801-5(a)(3), and have limited "unearned premiums" to situations in which the company has been actually "*paid* in advance." See Treas. Reg. § 1.801-3(e). There can be no question that this is a valid interpretation of a statute (§ 801(a)) which tells each company to compare "its" life insurance reserves with "its" total reserves. It is equally clear that the regulations leave no room for an attribution rule that is not based on actual or constructive receipt by the company sought to be charged with the reserve.

Further, Treasury regulations and the courts have long looked to state law to determine the amount of reserves allowable under the reserve ratio test. *See* Treas. Reg. § 1.801-5(a)(3), p. 3 *supra; Alinco Life Insurance Co.* v. *United States,* 373 F.2d 336, 345 (Ct. Cl. 1967). Never before has the Internal Revenue Service imputed a reserve to an insurance company in the face of uncontradicted evidence that the reserve was neither held by the insurance company nor required by the state authorities charged with monitoring the adequacy of that company's reserves.[6] Petitioner would

[6] Petitioner's recent contention that the reserves it seeks to attribute were "required by law," despite the Court of Claims' finding to the contrary (see Pet., p. 12 n. 5), is disingenuous at best in view of Petitioner's many representations below that it did not consider state law at all relevant on the attribution issue. We assume in any event that Petitioner is not asking this Court to devote its time to reviewing the decision of the Court of Claims on a point of Missouri insurance law.

usurp the legislative function of changing statutory and administrative law of 50 years standing without so much as giving affected taxpayers notice of the change under appropriate rule-making procedures.

In its petition in the companion case of *Consumer Life Insurance Co.* v. *United States,* 524 F.2d 1167 (Ct. Cl. 1975), petition for a writ of certiorari pending, No. 75-1221, Petitioner states (p. 14) that $28 million of taxes are at stake in cases involving "the issue."[7] While $28 million is not a trivial amount, the issues here cover a number of years going back at least to 1958 (as in *Consumer Life*) so that the average amount of taxes would seem to be less than $2 million per year. By contrast, the Solicitor General recently requested an extension of time in which to file a petition for certiorari in another life insurance company case, *Standard Life & Accident Insurance Co.* v. *Commissioner,* 525 F.2d 786 (10th Cir. 1975), where, we have been informed, the revenue impact of the issues in dispute is estimated in the range of 100 million dollars *per year.* In the event Petitioner does seek review of the *Standard Life* case, the Court may also wish to consider whether it should hear two cases involving only the taxation of life insurance companies in a single term.

Since Petitioner sees the need for a "uniform national rule" on the issue in this case (Pet., p. 11) it is worth noting that the Court of Claims is a court of na-

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[7] As noted below, *Consumer Life* actually raises two entirely separate issues. Petitioner does not specify what portion of the $28 million figure arises from the Penn Security attribution issue as opposed to the Consumer Life "substance over form" issue.

tional jurisdiction to which all taxpayers have access.[8] That Court has already considered the attribution issue carefully and with great deliberation. More than 21 months elapsed between argument and decision in this case, during which time there were two sets of supplemental briefs filed and a rehearing *en banc*. Given the technical complexity and limited importance of the issue, the Court should not use its limited and valuable resources to duplicate the Court of Claims' efforts when that Court has already given the companies affected not only a "uniform national rule" but a correct one.

Brief mention should be made of the Fifth Circuit's decision in *First Railroad & Banking Co.* v. *United States,* 514 F.2d 675 (5th Cir. 1975), a case which Petitioner tells us "followed" *Economy Finance.* That case involved not only different facts from the instant case but a totally different issue. The taxpayer was not a reinsurer like Respondent but a company issuing its own insurance policies to individuals and actually receiving unearned premiums paid in advance from its policyholders. Thus, the critical Treasury Regulations referred to herein were not at all involved, for the taxpayer could not maintain—as Respondent did successfully in the case at bar—that it never received "unearned premiums" as defined in Treas. Reg. § 1.801-3 (e) and that it never "actually held" such reserves as required by Treas. Reg. § 1.801-5(a)(3).

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[8] Petitioner concedes as much in its petition in the *Consumer Life* case (at p. 14) when it says that "since any insurance company may sue for a refund in the Court of Claims and invoke the authority of its decision in this case, the fiscal significance of the decision below potentially encompasses every pending case involving the issue."

The issue in *First Railroad* was whether the reinsurance label under which the taxpayer transferred unearned premiums to its parent company, the reinsurer, was *bona fide* or merely a facade for an agency relationship between the taxpayer and its parent. The taxpayer in *Consumer Life* was also the ceding company under a similar treaty,[9] but there was no parent-subsidiary relationship with the reinsurer in its case. *Compare Superior Life Insurance Co.* v. *United States, supra* and *cf.* section 482, I.R.C. 1954. In all events, no arrangement resembling the facts in *First Railroad* or Treaty II in *Consumer Life* was present in the case at bar. Petitioner's entire argument here is based on an acceptance of the substance of the reinsurance treaties between Respondent and the independent insurance companies.

Petitioner's suggestion (Pet., p. 13 n. 6) that the Court hold this case pending its disposition of *Consumer Life* is utterly inappropriate. Even if the Court finds a conflict on the substance-over-form issue raised in *First Railroad* and *Consumer Life's* Treaty II, there is no reason why the Court should not deny the Petition in this case.

On the other hand, should the Court decide to hear arguments on the attribution issue raised in *Penn Security,* Respondent should clearly be given an opportunity to be heard. *Penn Security* was the lead case in the Court of Claims; the "unearned premium" attribution issue in *Consumer Life* was decided on the authority of *Penn Security* (*see* Petition in *Consumer Life,* p. 81a).

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[9] Referred to by the Court of Claims as Treaty II. In addition Consumer Life acted as reinsurer under a treaty similar to that in the instant case, referred to by the Court as Treaty I.

Furthermore, in *Penn Security* Petitioner is faced with a record which nicely illustrates the arbitrary and unpredictable nature of its "reserves-follow-the-risk" theory. Since the cost of carrying Respondent's life insurance risks comprised more than 50% of the cost of all reinsured risks, it is much more difficult for Petitioner to argue that rewriting the statute and regulations so as to disqualify Petitioner from life insurance company status will somehow produce a result more clearly in line with a presumed Congressional "intent."*

CONCLUSION

For the reasons stated above, the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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* It would be particularly unjust to sacrifice Respondent's interests to Petitioner's litigating strategy when the amount of taxes Respondent has at stake in this case is more than 3½ times as great as the taxes at issue in Consumer Life. *See* Petition, pp. 57a-59a and *compare* Petition in *Consumer Life*, p. 92a.